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Why the Social Security Tax Cap Shouldn't Be Raised

BY DAVID R. HENDERSON

In recent months Senator Lindsey Graham, a Republican from South Carolina, has suggested making all earned income up to \$200,000 subject to the Social Security (FICA) tax. The current maximum on which Americans pay the tax is \$90,000. This maximum rises every year based on a government estimate of real wage growth in the recent past. Distressingly, President George W. Bush has refused to rule out such a tax increase. Pundit George Will, in a recent column that was favorable to the proposal, asserted that Graham's suggested tax hike "hardly blurs the distinction between conservatism and Bolshevism." Yet Will's own reasoning belies his assertion.

Marx's famous dictum was "From each according to his ability to each according to his need." And how does Will justify this tax increase? This increased tax, he writes, "would be paid mostly by Republicans—but also by the people most able to put substantial sums into the personal accounts that might become politically feasible only by raising the cap." In other words, the tax is justified, in Will's eyes, by ability to pay, which is the essence of communism.

Yet there is a strong economic, and a strong moral, case against the tax increase. First, the economics. Increasing the amount of taxed income would massively raise marginal tax rates for many of the most productive people. The marginal tax rate is the rate on the last dollar of income; non-economists typically call it their tax bracket. The marginal rate on those whose incomes are between \$90,000 and \$200,000 would increase by 6.2 percentage points for employees and by a whopping 12.4 percentage points for the self-employed. (Part of the 6.2 points paid by the employer would be borne by the employee. The actual split in the real burden of the

tax between employer and employee depends not at all on who nominally pays the tax; it depends entirely on the relative elasticities of supply and demand. But that's a longer story.)

Most people with earned income between \$90,000 and \$200,000 face a marginal tax rate of 31 to 40.5 percent. They are in a 25-to-33 percent federal income tax bracket. Their state tax bracket is probably about 6 to 9 percent. Of course, many high-income people itemize their deductions and thus can deduct their state taxes in arriving at their taxable income. So adjusted for the deductibility of state taxes on their federal tax form, the marginal state tax rate relevant to them is 4.5 to 6 percent. They also pay a 1.45 percent Medicare tax (2.9 percent for the self-employed) on all earnings. Thus raising the cap would increase the marginal rates of high-income employees by 15 to 20 percent. Raising the cap for the self-employed would increase their marginal rates by a whopping 31 to 40 percent.

A salaried worker making \$200,000 a year would pay \$6,820 more in taxes every year, while a self-employed worker would pay \$13,640 more. This would be the biggest tax increase on high-income people since President Clinton's and for many people would be a *bigger* tax increase than that. A rise in marginal rates would discourage work. The person previously in the 40.5 percent bracket would keep only 53.3 cents of an additional dollar earned, down from 59.5 cents before the tax increase. People would also find ways of being paid other than by

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taxable income, such as by receiving a company car. The employee considering a move to a less-desirable location for more pay, if he was just slightly inclined to make the move before the tax increase, might well say no.

It's not just the economics that makes the tax increase a bad idea. The tax increase is also morally wrong. Consider the fact that high-income people already get a lousy deal from Social Security. Of course, almost everyone gets a lousy deal: that's the nature of a Ponzi scheme, legal or illegal, for the latecomers, and today we're all latecomers. But high-income people get an even worse deal because the formula for Social Security benefits is heavily weighted in favor of low-income people. This is offset somewhat by higher-income people's longer life spans, but the net effect is still that high-income people, per dollar of taxes, do worse than low-income people. Presumably, benefits for higher-income taxpayers would not rise in line with taxes. Otherwise, why raise the tax in the first place? The purpose of the tax is to generate more revenue to solve the long-term funding problem. It would solve none of this problem if the government raised Social Security benefits dollar for dollar.

Furthermore, even if the government planned to raise Social Security benefits to help high-income people, that's little comfort. Many people are happy to save their own money for retirement. Currently, a few million Americans can look forward every year to reaching the existing threshold and knowing that the feds will keep their FICA hands off any additional income. We should be free to save that money or spend it as we wish.

How did we get in this situation where a President committed to tax cuts is considering a huge tax increase? The answer illustrates the old saw "Be careful what you wish for." Bush started with privatization as his goal. He wanted to figure out how to fund the budget hole left by letting people save in private accounts some of what would otherwise be taken in Social Security taxes. And then he noticed a juicy target: those who can well afford to pay the tax increase.

Wrong Goal

Some analysts have commented that Bush erred by having privatization as his goal rather than solving Social Security's long-term funding problem. Well, they're half right. Privatization is the wrong goal: at best, it's a means. But solving the long-term funding problem is the wrong goal too, because it takes as given that Social Security should be funded long-term. In other words, it accepts a program that is a form of perpetual intergenerational abuse. Each retired generation gets to tax the younger working generation, and when that generation comes of age it does the same, and so on. This intergenerational abuse must stop.

Bush would not have gone wrong if instead of asking, "How can I privatize?" he had asked, "How can I alter Social Security to reduce the size, intrusiveness, and injustice of this horrible government program?" Instead, he is poised to make Social Security more intrusive. What a tragedy it would be if a president who claims to believe in the "Ownership Society" ended up further violating our rights to our own income. 